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Corporate Financing in International Markets

by Patrick J. Davey

Management Summary

- Surveyed companies see a global market for capital emerging. Almost half of them have already tapped it and many of the remainder intend to in the future. The principal attractions: cost effectiveness and expansion of financing sources.

- Participants rely heavily on intermediaries to gain entry into international financial markets. Relationship, reputation, and expertise are the factors weighed most heavily in selecting underwriters for offerings and bankers for foreign loan syndications.

- Much in the way of experimentation has been attempted in international markets. Swaps, involving exchanges of interest rates, currencies, or both and note issuance facilities are two of the most popular innovations embraced by respondents.

- Government restrictions, capacity limitations and queuing requirements are among the barriers participating companies encounter in attempting to access certain foreign financial markets. But these are coming down and their removal is encouraging the internationalization of capital markets.

Financial Management Program

Profile of Participants

Respondents' Line of Business	Use of International Financial Markets: Number of Participants	Number of Nonparticipants	Total
Manufacturing (and mining)	28	36	64
Utility	11	13	24
Service	5	2	7
Financial	5	1	6
Transportation	1	4	5
Retail	2	—	2
Total	52	56	108

* * * * * * *

All six financial institutions have total assets well in excess of $1 billion. Annual volumes of the 102 nonfinancial respondents range from just under $100 million to more than $20 billion. Only 2 transact yearly sales of less than $100 million; 24 have sales in excess of $5 billion. The following tabulation classifies international market participation according to volume categories of the 102 queried nonfinancial companies.

Annual Sales of Responding Nonfinancial Companies	Number of Participants	Number of Nonparticipants	Total
Under $100 million	—	2	2
$100—$499 million	3	14	17
$500—$999 million	5	12	17
$1—$5 billion	20	22	42
Over $5 billion	19	5	24
Total	47	55	102

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Introduction

Not many years ago, U.S. corporations in need of external financing turned routinely to domestic sources of capital—investment bankers, insurance companies, commercial banks and the like—to satisfy their requirements for funds. As times have changed, so have the financing habits of some concerns. Nowadays, it is not unusual for companies to adopt a more global view toward funding sources. Indeed, it is becoming almost commonplace to see symbols for yen or pounds and names of foreign underwriters in tombstone advertisements for domestic issuers.

A number of factors have contributed to this emerging global market for capital. Principal among them: the maturation of the Euromarket (see box); the increasing accessibility of various foreign domestic capital markets, such as that of Japan; the removal of tax barriers to investment; the differences in investors' standards in various markets; and, importantly, the introduction of innovative financing techniques including "swaps" facilitating currency and interest rate exchanges.

This survey was undertaken to review recent and planned international financing practices of domestic corporations. Questionnaire responses from senior financial executives in 108 U.S. companies, together with information developed in interviews with a limited number of these respondents and other knowledgeable executives, form the cornerstone of this report.

The most significant findings are that: (1) The Euromarket and foreign capital markets function largely as debt markets. (2) Larger companies are more likely than smaller ones to raise funds in international markets. (3) Most companies, regardless of size, are aware of and enthusiastic about, financing opportunities abroad. (4) Multinational companies are not the sole users of international financial markets; and (5) Obstacles—for instance, queuing requirements in some countries—slow, but do not block, the development of a global capital market.

Thus far, participants have entered the international markets with a variety of debt offerings. They have not issued equities although some intend to offer convertible securities in the future.

Among respondents participation in international markets increases directly with sales or size. The second tabulation in the accompanying box makes the relationship evident.

Many of those queried, whether or not presently borrowing outside the domestic market, plan to consider foreign sources when the need for funding next arises. Such companies intend to explore all the alternatives in their quests for financial support.

Regular reliance on international markets by utilities and financial institutions, whose activities are largely, if not entirely, domestically focused, shows that foreign financings are hardly the exclusive domain of multinational companies. Concerns are paying less attention to geography and more to attractiveness of deals in arranging financings.

Barriers continue to retard access to certain foreign markets. But they are falling—those of a tax nature, for example — and their removal, according to respondents, is doing much to spur the internationalization of the capital markets.

Evolution of the Eurocurrency Market

From humble beginnings less than 40 years ago, the Eurocurrency market has grown apace. Estimates place total 1985 Eurobond issues at over $125 billion.[1]

What accounts for this rapid development? The Eurocurrency market sprung up following World War II when the dollar assumed its role as the premier trading currency. Eastern European countries, especially the Soviet Union, needing dollars to finance imports from the United States but fearing dollar accounts might be impounded if held in banks subject to the jurisdiction of the United States, started depositing dollars with European banks. Later, in the 1960's, low-interest rate ceilings imposed on United States banks prompted depositors to look elsewhere for higher returns. Many turned to European banks, which, free of interest rate restrictions and reserve requirements, were able to offer depositors greater inducements. The opening of foreign branches and subsidiaries by U.S. banks provided an additional spur to the growth of the Euromarket.

Further impetus came from the market's relative freedom from regulation. For example, the speed with which borrowers can enter the market proved a major attraction. Indeed, shelf registration, recently introduced in the U.S. capital market, is an attempt to accelerate the domestic underwriting process and make it competitive with that abroad.

Efforts to deal with the U.S. balance-of-payment deficits through regulations and the accumulation of great wealth by oil-rich nations also contributed to the growth of the Euromarket. So did the market's demonstrated ability to fill a variety of financing needs quickly and efficiently. More recently, easing of controls by various governments and refinancings prompted by interest rate declines have fueled market expansion.

[1]World Financial Markets, Morgan Guaranty Trust Company of New York, January 1986.

Recent and Proposed International Financings

Fifty-two, of the companies surveyed, or just under half, have engaged in international financings of one or more kinds during the past two years. All of these fund-raising efforts have been debt oriented. As Table 1 indicates, bank borrowings loomed large among recent international financings accomplished by participants in all business categories. Besides term loans, respondents have arranged revolving credit and standby agreements with international banks. And a number also have borrowed from foreign banks in local currencies to support the working capital needs of subsidiaries.

While those queried have obtained some capital in foreign domestic capital markets, far more emphasis was placed on fund-raising efforts in the Eurocurrency market through Euronote and Eurobond offerings. (See Glossary). Euronote transactions included zero coupon, floating rate and note with warrant issues. Eurobond offerings included Eurosterling, Euroyen and zero coupon bonds. Foreign capital market borrowings consisted of issues in Canadian dollars, Swiss francs, Japanese yen and English pounds.

Many responding firms state that international financing plans for the next two years are moot, or that all available sources including those abroad will be considered as their funding requirements become apparent. Even among the twenty-six companies with fairly definite near-term intentions of participating in international financings, nine are uncertain as to what forms fund-raising efforts will take (Table 2). Members of this undecided group make it a practice to monitor international markets and seize opportunities when matches between needs and circumstances arise.

Foreseen financings are, for the most part, new borrowings along conventional lines. Exceptions are the plans of four companies to establish revolving underwriting or note-issuance facilities (discussed on page 10). These arrangements and swap transactions, which are suggested in Tables 1 and 2 (by the foreign capital market financings), are among the quite numerous innovations now achieving prominence in international debt markets.

Line of business does not appear to have influenced the type of borrowing accomplished by respondents. Utilities, for example, spread their fund-raising efforts among credit and capital markets just as manufacturers did. Similar approaches were taken by participating retail, transportation and service companies suggesting a broad pattern of planning flexibility designed to permit the reaping of favorable funding arrangements wherever they existed.

Future plans, as shown in Table 2, indicate that responding companies will continue to tap a variety of international financing sources. But early indications are that greater overall reliance will be placed on raising funds through security issues than through straight bank borrowings.

Table 1: International Financings (1983-1985) by 52 Participating Companies

	Number of Companies						
Financing Approach Employed	*Manufacturing*	*Financial*	*Retail*	*Transportation*	*Utility*	*Service*	*Total*
Foreign bank borrowings	23	4	2	1	13	6	49
Euronotes	13	2	8	1	5	1	30
Eurobonds	9	6	1	—	8	3	27
Foreign capital market borrowings	5	3	3	—	1	1	13
Dual currency borrowings	1	1	1	—	1	—	4
Other	1	—	—	—	—	1	2
Total	52	16	15	2	28	12	125

Table 2: Proposed International Financings (1985-1987) by 26 Participating Companies

	Number of Companies						
Financing Approach Contemplated	*Manufacturing*	*Financial*	*Retail*	*Transportation*	*Utility*	*Service*	*Total*
Eurobonds	5	3	—	—	1	1	10
Foreign capital market borrowings	2	2	—	—	2	1	7
Foreign bank borrowings	4	—	—	—	2	—	6
Euronotes	2	1	—	—	1	2	6
Revolving underwriting or note issuance facilities	2	1	1	—	—	—	4
To be determined	9	3	1	—	—	1	14
Total	24	10	2	—	6	5	47

Reasons for International Financings

Whether for completed or planned international financings and regardless of type of financing, companies usually give cost effectiveness, expansion of funding sources, or both, as explanations for tapping overseas markets. Other reasons, occasionally offered for using international financial markets, include: the opportunity to obtain arbitrage profits; the less restrictive nature of borrowing covenants; the desire to hedge overseas assets; freedom from domestic regulatory restraints; term, tax and foreign-exchange considerations; the easier, less voluminous documentation required for issues; and the expectation that foreign borrowings will, by producing favorable publicity, increase demand for the equity of debtors.

All-in (total) costs for Eurocurrency and foreign capital market issues comprise interest rates, underwriting charges and, often, swap fees. Underwriting fees abroad tend to be higher (perhaps 2 percent versus .5 percent, for example, on a $200-million bond issue) than those assessed domestically. And currency swap fees, perhaps .3-.5 percent of the amount involved, also add to costs. How, then, can international financings offer lower total costs to issuers? The answer lies in coupon or interest rates that on occasion prove sufficiently lower than domestic rates to offset the domestic market advantages of less costly underwriting fees and absence of swap outlays. Total savings of 25-100 basis points have been realized on international financings.

Why are lower interest rates sometimes available to U.S. borrowers in international markets? There are several reasons including foreign investors' general distrust of the securities of unstable governments and fondness for the securities of "name" U.S. companies. These inclinations occasionally help produce a premium—lower coupons—for the issues of well-regarded U.S. companies, especially when offered in bearer form. (Under the Tax Reform Act of 1984, domestic corporations are now empowered to issue bearer bonds directly abroad.) Of course, lower inflation rates, more favorable economic conditions, and governmental policies that are advantageous to business sometimes result in lower interest rates being available in foreign capital markets—that of Japan, for example—than in the United States. Lower costs of capital coupled with innovative packaging of loans also enable some international banks to offer competitive rates.

Many financial executives of U.S. companies have broadened their horizons beyond customary borders to ensure an adequate supply of funds. Past volatility in the domestic market has induced some to look elsewhere for assistance. So has the drying up of demand for certain kinds of issues. Recommendations of investment bankers, many of whom have adopted a more global outlook in arranging financing, have spurred others to use the international financial market. And the successful experience of peers has prompted still others to look to the Eurocurrency market as a means of diversifying or expanding financing sources.

Of course, some companies are attracted to the international financial market by the hedging and arbitraging opportunities it offers. Protecting a long position in foreign assets by borrowing in the currency in which they are denominated appeals to some. Using zero-coupon Eurodollar note proceeds to purchase United States Treasury notes to create profits attracts others!

[1]Ann Monroe, "Financial Ploys," *The Wall Street Journal*, January 16, 1985, p. 1.

Glossary

As with many areas of finance a special language has sprung up to describe various aspects of international fund raising efforts. Definitions of some of the terms commonly encountered in such dealings follow:

- Eurodollar—dollar on deposit in a bank located outside the United States.
- Eurocurrency—currency on deposit in financial institutions located outside the country of the currency's issue—for example, sterling on deposit in a French bank.
- Eurobond—long term obligation issued in countries other than the country in whose currency it is denominated.
- Euronote—short term obligation issued in countries other than the country in whose currency it is denominated.
- Eurocurrency market—sometimes simply referred to as the Euromarket. It is a network of world-wide banks at least a portion of whose deposits are denominated in currencies other than that of the countries in which they are located.
- Eurodollar bond—dollar denominated bond issued outside the United States.
- Euroyen bond—yen demoninated bond issued outside Japan.
- Samurai bond—long-term obligation of a non-Japanese company denominated in yen and issued in Japan's capital market.
- Bulldog bond—long term obligation of a non-British company denominated in pounds and issued in the United Kingdom.
- Dual currency obligation—long term bond that is denominated and pays interest in one currency but that is redeemable in another—for example, a bond that is denominated in Swiss francs and pays interest in Swiss francs, but is redeemable at maturity in U.S. dollars.
- ECU—acronym for European Currency Unit. A basket of currencies composed of specific quantities of the currencies of member countries of the European Community.
- Foreign domestic capital market—the national market of a country when used by an issuer domiciled in a different country—for instance, the Swiss capital market when being used by a U.S. firm.
- LIBOR—London Interbank Offered Rate—is the interest rate at which banks in the London Euromarket offer funds to other banks.
- Tranche—portion of an entire financing—for example, a $500 million borrowing might be drawn down in five distinct parts (tranches) of $100 million each. Or an issue distributed in three markets would have a tranche for each.
- Zero coupon bond—long-term debt instrument priced substantially below par at issuance, which pays no interest, currently. Investor returns come from redemption of the bond at par at maturity or from its sale prior to maturity whenever it sells at a price in excess of the issue price.

The following comments by participants present representative explanations for the use of the international financial market:

> "The Eurobonds were issued to obtain the lowest dollar—equivalent interest rate available with 'properly priced' instruments and to increase the company's exposure to the Eurocapital markets. The debt currency swaps were utilized to hedge our net asset positions in the respective currencies, and the Eurosterling bond also was utilized in part to hedge our net asset position in sterling. The U.S.-dollar financing and standby facilities were also the most efficient and cost-effective vehicles available. The foreign local financing for foreign needs is usually the most efficient from interest rate, logistic and foreign-currency-exposure management perspectives."
>
> *Assistant treasurer, a service company*

* * * * *

> "The company has pursued a strategy of entering the global capital markets as a means to expand its investor base and, at the same time, achieve the lowest possible cost of funds. Since foreign investors' market outlook and yield requirements may differ from U.S. investors' perceptions and requirements for various reasons, the Euromarket from time to time may offer cost savings, compared to comparable note issues in the United States."
>
> *Director-corporate financing, a financial organization*

* * * * *

> "Both financings were cost-effective means of raising long-term debt and tapping new sources of capital. The terms of both financings (interest costs, maturity and financial covenants) were materially more advantageous than those available in the United States capital market."
>
> *Director-corporate finance, a mining company*

Dependency on International Markets

Among 32 companies providing details on the extent of their reliance on international markets for financing, foreign borrowings range from 1 percent to 50 percent of total borrowings with a median of 20 percent. Table 3 indicates how these companies expect their relative dependence on the Euromarket and foreign domestic capital markets to change by 1990.

Fifteen of those making a forecast see their reliance on international markets intensifying by 1990. They offer several reasons for this expectation, including the trend toward deregulation in several foreign domestic capital markets (which makes them more accessible); the attractive cost opportunities presented; the continued development of creative techniques that will foster the use of offshore markets; and the growing perception among investment bankers that a worldwide capital market exists. The treasurer of a service company, whose debt raised in foreign markets accounted for 11 percent of its total indebtedness at year end 1984, explains why the organization may increase its dependence on foreign markets:

"We expect that this percentage could increase by 1990 because of the relatively good rates in Europe and the relaxation of withholding tax regulations. For large corporations, debt issuance is considered on a global basis and not necessarily on a national basis. We expect that we may have a debt issue in the future that will be sold in both the overseas and domestic capital markets."

Table 3: Expected Future use of International Financial Markets, 32 Companies

By 1990	*Number of Mentions*
Reliance expected to increase	15
Reliance expected to remain steady	8
Reliance expected to be shaped by future developments	8
Reliance expected to decline	1
Total	32

One-fourth of those making predictions anticipate little change in the extent of their reliance on international markets during the next five years. Another 25 percent believes future developments—market conditions, interest and exchange rates, for example—will determine whether greater use will be made of offshore markets. Only one company expects reliance on foreign financings to fall. It plans to reduce the amount of debt in its capital structure—a strategy likely to prompt domestic equity financing and discourage borrowing from any source.

Companies not Using International Financings

More than half (56) of the companies queried have not as yet used the international markets to secure financing for corporate purposes. But several of them report borrowings in local currencies by—or on behalf of—foreign subsidiaries, usually to avoid the exchange risk involved in dollar financing. Reasons advanced for not raising funds in offshore markets, listed in frequency of mention, are:

- Nature of financing requirements
- Preference for domestic funding sources
- Insufficient economic inducements
- Problems with available maturities

Many of the nonusers of international markets indicate that they are generating sufficient funds internally to make external financing, domestic or foreign, totally unnecessary. Others state that very little in the way of external support is needed to maintain operations and, what is, is readily obtained through established domestic sources.

Some of those that express a preference for domestic funding point to satisfaction with earlier financings to explain their position. Others maintain that less than top-rank debt ratings impede their access to international markets.

Several fail to find economic advantages in overseas markets. A manufacturing company, for instance, took competitive bids on a $100-million, 10-years issue, in both the domestic and Euromarket, and found the U.S. market provided a savings of 6 basis points. And a few indicate that domestically issued commercial paper is less expensive than borrowing short-term abroad.

Maturities for Eurobonds, usually five to twelve years, are shorter than those for their domestic counterparts whose terms

commonly extend from fifteen to twenty-five years, or even longer. This difference turns a number of those queried away from international markets. "We want to match our liabilities with our assets which generally have 40-year depreciable lives," says the assistant treasurer of a utility in pointing out one of the reasons the company has not raised funds in foreign markets.

Lack of familiarity with the working of the international financial market dissuades some companies from approaching it. Conviction that they are not well enough known and respected by investors abroad convinces others to confine financing efforts to the domestic marketplace.

Possible Future Use

Forty-four of the companies not presently raising funds abroad believe they may attempt to gain access to the international markets in the future. In fact, twelve of them are contemplating such financings at the present time. Many of the remainder report that they will not hesitate to make entry when company financing needs can best be filled in international markets. For example, the vice president and treasurer of a diversified manufacturing company states:

"We view Eurodollar or foreign-denominated bonds, loans, and so on, as a potential source of financing that can be used to augment domestic borrowings. The decision to borrow short or long term in either the domestic or foreign markets is governed primarily by one or more of the following criteria: (1) the effective all-in interest cost, (2) maturity, (3) prepayment rights, (4) foreign-exchange exposure as it relates to non-U.S.-dollar funding options, and (5) any unduly restrictive covenants which might hamper future expansion of operations."

The dozen that do not anticipate accessing the international markets give several explanations for their expectations. Among them: regulatory constraints that prevent their taking advantage of windows (advantageous placement periods); conservatively oriented boards of directors, that look askance at all forms of foreign financing; and financial conditions within the company that make the probability of raising external funds from any source in the foreseeable future remote.

International Financing Procedures

When a company's management decides to raise funds in international markets, it must determine whether to proceed through a public or private offering, or through borrowings from banks. Either way, the company must first address the task of getting ready for market entry. Then it must go about the job of appointing a representative to act as an intermediary in securing the desired financing from investors. Finally, the company must cooperate with its chosen representative in the selling effort.

Preparing to Enter the International Market

Participants in this survey stress that international financial markets are "name" markets. International investors are not so much concerned about the quality of the paper they are purchasing (although credit standing does have relevance) as they are about the reputation of its issuer.

To prepare for market entry a company must first become familiar with the workings of the Euromarket and foreign capital markets. And then it must get itself known in the proper circles.

How can these challenges best be met? While company approaches vary with knowledge and exposure levels, the following general course of action is suggested for newcomers by an experienced investment banker:

"First, you should detail a couple of your brighter associates to learn all about the technical aspects of issuing Eurobonds, interest rate and currency swaps, and revolving underwriting facilities. With this knowledge under their belts they will be in a good position to decide what best suits the company's requirements and whether or not to pursue international financing possibilities further. A visit to an investment banker's offices in New York or London could be helpful in this respect... .

"After the technical side is absorbed, it is important for members of the international study team to get themselves into the flow of market information about Euroissues and swap opportunities. This can be done in various ways, by studying interest rate and foreign-exchange data on a regular basis, tracking and comparing international market opportunities with domestic alternatives, and by having periodic conversations with investment banking and capital market representatives of the various firms with which you are in touch. In any event, members of the team should develop a couple of 'insider'contacts with whom to discuss issues and rates on an ad hoc basis.

"The next step, assuming the decision is now made to plan for an international issue, is to focus on preparing the market for your entry into it. This can involve several months, and we recommend that it have three parts to it. The first of these is to plan an equity-information meeting both at luncheons and on a one-on-one basis with leading portfolio managers in London, Zurich, and possibly one or two other cities. As a part of these meetings, visits can be scheduled with some leading Eurobond houses to acquaint or reacquaint them with the company and to tell its 'story' from the debt-financing point of view.

"The second part might well be a bank borrowing or (arranging a standby credit facility such as a revolving underwriting facility). This will tend to bridge the gap between the first part, and the third—which is to select a lead manager for a prospective Eurobond issue, and several of the co-managers that the lead manager will propose to distribute the issue. This advanced selection, which we call presyndication, preferably

Table 4: Criteria Influencing Selection of International Underwriters

Criterion	*Number of Mentions*
Established relationship	25
Unblemished reputation	16
Demonstrated expertise	14
Outstanding distribution ability	10
Cost competitiveness	9
Adequate strength	6
Creativity in packaging deals	5
Other[1]	2
Total	87

[1]Competitive bidding and security specialization

would be made before the time of the information meeting, but otherwise not long after. Once the management group is chosen, we like to organize a presyndication dinner in London for first-time issuers in the market, where representatives of the company can meet face to face with the group that will be underwriting its issue. This meeting usually occurs two to six weeks prior to launching of the issue, but it may be longer if the right market conditions do not materialize in that interval. The main idea behind presyndication is to get a top-level commitment from the whole group to back the issue, and to use the opportunity also to make sure they understand all the 'selling points' associated with it. Then, with the group ready and primed, one waits for the right moment, usually the early phase of a market rally or when an attractive swap opportunity is presented, and pops the deal in at relatively short notice. Thus, the issue is launched before the end of the market rally, when conditions are less favorable, into the hands of underwriters who are fully prepared for it and who have had time to organize their sales efforts. We have used this procedure for new issuers many times in the past and have almost always found it to produce very satisfactory results for all concerned."[2]

Selecting Underwriters and Lenders

Ten years ago, a panel of United States companies was asked what criteria they employed in choosing underwriters for their predominantly domestic issues.[3] The characteristics most prized by that group included: outstanding reputation, proven marketing capability, counseling expertise, innovative financing ability, ready accessibility, quality personnel and reasonable cost structure. Overlapping but not identical requirements exist today for investment bankers handling international issues. Companies taking part in this survey expect chosen investment representatives to demonstrate some or all of the attributes outlined in Table 4.

[2]Address on "Satisfying Corporate Financing Requirements" by Roy C. Smith, General Partner, Goldman Sachs & Co., at The Conference Board's 1985 West Coast Financial Conference, San Francisco, April 25, 1985.

[3]Patrick J. Davey, *Investment Banking Arrangements*, Conference Board Report No. 681, 1976.

Many companies prefer to arrange international financings through organizations with which they have had satisfactory dealings in the past. A history of well received underwritings whether in the domestic market, the international market, or both, gives them confidence that planned offshore financings will go smoothly. So such companies often arrange overseas financings through their intermediaries for domestic issues: investment or commercial banks, many of which have overseas representation through subsidiaries, affiliates or joint ventures. (See accompanying box). On occasion, of course, foreign banks, with which ties have been previously established, are chosen as lead managers.

An unblemished reputation is frequently mentioned as a desired trait in investment bankers. Companies fear that any breach of integrity on the part of their representatives in financial markets would redound to their own detriment. So they are careful to select intermediaries known for uprightness in handling not only underwritings but also personnel, consulting and other support matters.

A proven track record is another criterion many consider when making a choice among prospective intermediaries. For example, a U.S. company contemplating an offering in the Bulldog market might eliminate as candidates all bankers that have not successfully negotiated several placements in the United Kingdom regardless of their accomplishments elsewhere.

Ability to place an issue in accordance with a client's wishes—for example, with a broad mix of institutional investors —is another characteristic that companies value highly in the investment banker chosen to market their issues. Past accomplishments in this regard are weighed heavily by those to whom efficient distribution is a major factor in the selection process.

Competitive pricing of services and the requisite financial strength to ensure completion of underwritings are other characteristics greatly appreciated by companies seeking international intermediaries. So is innovativeness in designing and carrying out financings.

International Intermediaries

The Glass-Steagall Act, which bans commercial banks from engaging in basic corporate domestic underwriting activities, has failed to put a damper on these banks' international fund-raising efforts. In overseas capital markets, affiliates of several large domestic banks have provided first-rate competition not only for the established European merchant banks but also for Wall Street's investment banking firms.

Demonstrating inventiveness, tractability and eagerness, the foreign arms of domestic commercial banks have obtained a goodly share of mandates from firms anxious to raise funds in the Euromarket. As intermediaries they have arranged a variety of financings in the international marketplace including foreign currency offerings, swaps and commercial paper arrangements. The success of their efforts is reflected in the standings of lead managers where they hold a number of prominent positions.[1]

[1]See, for example, "Euromarket Borrowing," *Euromoney Corporate Finance*, February, 1985, pp. 9-20.

For several participating companies the selection process does not end with the choosing of a lead manager for an issue in the international market. As the following comment by the treasurer of a participating service company makes clear, opinions on the makeup of the overall underwriting group are sometimes offered:

"Recently, we have limited the selection of lead manager for debt issuance to those bankers that we currently utilize in other areas. We select the lead manager from within our banking group on the basis of experience and price for the specific debt offering we are considering. Once the lead manager is selected, then that manager typically has the freedom to select the underwriting syndicate. However, we will suggest other bankers with whom we presently have relationships be part of the underwriting syndicate."

In selecting banks to lead foreign loan syndications, most participating companies say that the same criteria used to choose underwriters apply. Some, however, put greater emphasis on the importance of an existing relationship in naming a lead bank. And for others the focus is, in the words of one chief financial officer, "more on traditional banking strengths compared to capital market strengths."

Bringing a Deal to Market

From start to finish a successful Eurobond issue can be completed in about a month. The process involves announcement of the issue, formation of a syndicate, completion of a road show by company executives and lead managers, preparation of the issue for listing, agreement on pricing, offering of securities and payment for them.

The lead manager or, as sometimes called, managing underwriter, of an international note or bond issue assumes several responsibilities. Included are: negotiation of the amount, conditions and timing of the offering; participation in the preparation of an information bulletin or prospectus; arrangement of a management group and underwriting syndicate; and coordination of all distribution efforts.

Provided the issuing company and chosen lead manager reach agreement on the key ingredients of a proposed financing—type, amount, approximate price, fees and the like—a written mandate is given to the lead manager to proceed. At this point, legal, accounting and other needed specialists are invited to participate in the process. The information these experts develop is often incorporated in the prospectus for the issue.

Unless the offering is expected to be quite moderate in amount, inducing the lead manager to assume complete underwriting responsibility, others are invited to participate and an underwriting syndicate is formed. Such syndicates facilitate marketing, spread risks (and profits), and encourage intermediaries to include one another in future deals any of them may lead.

Besides the lead manager a syndicate may include one or more co-managers, a number of underwriters and, if the issue is large, a selling group. The management team usually commits jointly and severally to buy the entire issue, but only after lining up a sufficient number of underwriters to dispose of it. In addition, managers usually work out an agreement among themselves to define limits of individual responsibility. Members of the selling group do not have legal underwriting responsibility, that is, they are not bound to purchase proportionate shares of issues that go unsold in original offerings. However, their selling commissions could be threatened by exclusion from future syndications should they fail to perform as expected.

Pricing (i.e., establishment of the rate of interest to be paid by the issuer,) is probably the single most difficult aspect of an underwriting of debt securites. Issuers want the lowest possible interest cost; investors, the highest return. Underwriters strive to reconcile these conflicting objectives without damaging their own positions. These efforts are not always successful. For example, early in 1985, a number of Eurodollar bond issues were offered with coupons considerably below those attached to similar issues in the domestic market. The result: Issuers were pleased but underwriters were bruised because they were forced to absorb substantial portions of these issues into their own portfolios as investors turned away from them in search of higher returns elsewhere.

In the case of a syndicated Eurocredit, the lead bank also plays an important role. It assembles the other members of the syndicate, managing and participating banks; prepares a placement memorandum describing the financial condition of the would-be borrower and terms of the proposed credit; and markets the loan.

If the loan is fully underwritten, the lead and managing banks agree to provide the total amount of the requested loan. To keep the commitment, the lead bank will usually offer for placement more of the loan than it intends to distribute, realizing that not all banks approached will choose to participate. When the placement is complete, the lead bank and managing banks may retain 50 percent or more of the credit on their own books.

Term loans are the usual products of Eurocredit syndications. While many of these borrowings are amortized over their lifetimes, some have so called bullet repayments in which the entire loan is repaid at maturity. Arrangement ordinarily consumes from two to twelve weeks.

Pricing of Eurocredits is related to the borrower's credit quality and to market conditions. The interest rate is normally a spread over LIBOR, although other bases may be employed, or the rate may be adjusted periodically.

Influence of 1984 Tax Legislation

In July, 1984, federal income-tax legislation was enacted that contained a major provision repealing the previously effective 30 percent withholding tax on interest payments to foreign investors. Table 5 indicates how the passage of this law (The Tax Reform Act of 1984) influenced the execution and the cost of Euromarket borrowings among the survey participants who commented on this point.

Prior to enactment of the 1984 legislation, it was necessary to issue dollar obligations abroad indirectly to circumvent withholding requirements. Some large companies established financing subsidiaries, many of them in the Netherlands An-

Table 5: Impact of Tax Legislation on Euromarket Offerings

Effect	*Number of Mentions*
Facilitated accomplishment of issues	13
Lowered cost of issues	8
Negligible influence	7
Other	3
Total	31

tilles, to accomplish this end. But many smaller firms did not do so because they were unwilling to assume the financial and administrative burdens required to maintain such units. Now all U.S. companies enjoy direct access to the Euromarket with the concomitant benefits of quicker delivery and smoother implementation. "The removal of withholding tax requirements on foreign holders of domestic bonds," says the vice president and treasurer of a participating manufacturing company, "has essentially made transactions in the Eurodollar market easier to execute, with simpler documentation and, generally, less complexity."

Eight survey participants report that lower costs have resulted from repeal of the withholding requirement. But this benefit flows not so much from lower interest rates obtained in foreign markets as it does from reduced administrative costs in connection with the financings. While some international issuers did get lower-cost coupons abroad in the months immediately following removal of withholding regulations, such rate advantages traced largely to special factors. These included soaring demand for U.S.-dollar-denominated debt by foreign investors and the desire to demonstrate continued viability by foreign underwriters that were facing stiff competition from rivals in the United States. Recently, spreads have narrowed between domestic and Eurodollar rates and cost savings presently trace mostly to reductions in overhead in connection with international financings. However, the treasurer of a service company wonders if savings in administrative outlays result in net gains for domestic issuers in international markets:

"The removal of withholding tax requirements has made the execution of offerings in Europe significantly easier. This is because there is no need for a Netherlands Antilles corporation to eliminate withholding on foreign-held securities. It is questionable whether the cost of borrowing in the Euromarket has been reduced. Although some issuance costs were removed with the withholding tax change, the Euromarket has seen more and more offerings from U.S. issuers and the spread to the U.S. market has decreased. Consequently, although we may have reduced our issuance costs, the ability to obtain rates below those of the U.S. market in Europe has diminished as well."

Seven cooperating companies reported little, if any, effect from changes in withholding rules. This is because they have either not done any financing in the international markets since the passage of the legislation or they believe that the cost savings are inconsequential. Two companies mention that it has become necessary for them to provide foreign investors with indemnification against the possible reimposition of tax withholding during the life of issues. And one company indicates that the removal of withholding increases the likelihood of its launching an issue in the Euromarket.

Innovative International Financing Approaches

Innovation has been anything but a stranger to international financial markets. Much in the way of experimentation has taken place. Bankers have devised many new instruments to ease market access for clients.[4] Two of the approaches they have pioneered, swaps and note issuance facilities, have come to the fore.

Swaps

Earlier in this decade, the term "swap" referred to a transaction in which a company exchanged its own common shares for its own outstanding bonds. The bonds were purchased in the marketplace by middlemen, usually investment bankers, at substantial discounts from their par values because of sharp increases in interest rates during the time they were outstanding; then the bonds were swapped for comparable dollar amounts of common stock. The net result: Companies retired bonds at favorable prices while strengthening debt ratios, and investment bankers earned commissions and, in some cases, profits on the shares received when they ultimately sold them to other investors.

But times have changed, and so has the meaning of the word "swap." Nowadays, swaps come in several varieties and do not ordinarily relate to exchanges of shares of stock for bonds. Rather, they involve exchanges of interest rates, currencies—or both. Their role in international finance is growing in importance. Estimates indicate swaps played a part in 60 percent of 1985 international capital market issues.[5]

[4]For a discussion of recently employed techniques and instruments see "A Checklist of New Techniques," *Euromoney*, London, October 1985, and Henry Kaufman and Jeffrey Hanna, *Prospects for Financial Market in 1986*. New York: Salomon Brothers, Inc., 1985 pp. 34-39.

[5]James Sterngold, "Raiding of the Rate Swappers," *New York Times*, January 14, 1986.

Interest Rate Swaps

Interest-rate swaps ordinarily consist of the exchange between two counterparties, often with the assistance of a third party acting as an a go-between or temporary principal, of a floating rate of interest for a fixed rate of interest in the same currency for a specified term. But they may involve the exchange of floating rates of interest computed on different bases—prime rate and LIBOR, for example. Either way, the transactions do not require any exchange of principal but only agreement to assume responsibility for the other party's interest payments.

At their inception, interest rate swaps usually involved foreign banks and domestic corporations with less than top quality credit standings. But participating parties have expanded to include a wide mix of corporate and financial institutions throughout the world.

Perhaps the greatest inducement for entering an interest rate swap is cost savings for both parties. How can each reduce interest outlays? Consider for purpose of illustration the case of international Bank X and lower-rated manufacturing Company Y. The former wants to secure floating-rate dollar financing; the latter, fixed-rate dollars. But expensive interest-rate structures in the respective markets make proceeding as indicated impractical. Instead, Company Y manages to borrow at a relatively favorable cost in the floating-rate market, and Bank X similarly borrows a like amount in the fixed-rate market. An agreement is reached between X and Y, whereby the respective interest liabilities are swapped, or exchanged. The bank, which had been the fixed-rate borrower, becomes the floating-rate payer, and vice versa. The net result: Company Y and Bank X each gets lower rates, perhaps 50 basis points or so, than if it had borrowed in its preferred markets directly. Company Y reaps the benefit of the interest saving accorded the higher-rated Bank X. To induce the bank's participation in the swap, Company Y shares its savings with bank X by dropping the rate it has passed along. This reduction, while lowering Company Y's gain, enables Bank X to assume a repayment obligation lower than would have been the case had it borrowed directly in the floating-rate market.

Beside the benefit of cost savings, interest rate swaps offer other advantages. For one, they enable participants to reap profits (or cut losses) through the mechanism of swap reversals, if interest rates swing in the opposite direction. For another, they enable companies effectively to utilize markets that might not otherwise be available to them, and to do so quickly since clearance, reporting and disclosure requirements are minimal. Still another benefit is that they provide flexibility by permitting companies to stretch out the effective maturity of short-term borrowings—commercial paper obligations, for example.[6]

Currency Swaps

Currency swaps in their most uncomplicated form have three elements: (1) an initial exchange of principal amounts of two currencies; (2) an ongoing exchange of interest payments at agreed upon fixed rates during the term of the agreement; and (3) a reexchange of principal amounts at maturity. For example, Counterparty A might swap the proceeds of a Swiss franc denominated bond issue with Counterparty B for U.S. dollars to launch an arrangement. Then, at intervals, during the course of the swap agreement, each counterparty makes interest payments for the other in accordance with preset fixed rates. Finally, to conclude the swap, the counterparties reexchange the principal amounts traded initially.

These arrangements had their genesis in the 1960's when, companies would arrange back-to-back loans with each other in order to circumvent foreign-exchange controls and secure desired currencies. For example, a foreign company would lend local currency to the subsidiary of a U.S. company located in its country while, simultaneously, the U.S. parent would lend an equivalent amount in dollars to the foreign company's subsidiary in the United States. Currency swaps simplified the process in many instances.

Fixed-rate currency swaps resemble foreign-exchange contracts but provide greater flexibility, by permitting the fine tuning of maturities and amounts, for example.[7] Like interest rate swaps, currency swaps offer counterparties opportunities for savings by allowing them to take advantage of special opportunities in particular markets. Of course, they also permit companies to obtain currencies that might otherwise be either more difficult or expensive to secure.

Combinations

Combined interest rate and currency swaps, known also as currency coupon swaps, cross-currency interest rate swaps and circuses, include the features contained in both types of swaps. A circus, consists of the swaps of principal amounts of two currencies at a specified exchange rate, the exchange of floating rate interest payments in one currency for fixed rate interest payments in another currency, and the reswapping of principal amounts at maturity.

These combination swaps, though somewhat complex, find a variety of useful applications—in foreign leasing transactions, for example. And they offer many of the advantages held forth by their component swaps, including cost savings.

Application and Arrangement

Twenty-three participating companies have used swaps in connection with recent international financings. Ten entered interest-rate swaps; eight, currency swaps; and five, combinations of the two. Five other companies have swap arrangements of one kind or another under active consideration.

The fourteen concerns commenting on the arrangement of swap transactions indicate they paid fees to financial institutions—six investment banking firms, four commercial banks, and four lead managers—to arrange deals with counterparties and, in some cases, to guarantee performance of the

[6]For illustrative examples, see Tanya S. Arnold, "How to do interest rate swaps," *Harvard Business Review*, September-October, 1984, pp. 96-101.

[7]For detailed discussion of foreign-exchange transactions, see Roger M. Kubarych, *Foreign Exchange Markets in the United States*," Federal Reserve Bank of New York, 1978.

counterparties. Finding other organizations with interest rate or currency needs that can be filled with a swap is no easy task for companies engaged in manufacturing, service or other commercial activities. Indeed, it is sometimes a difficult undertaking even for institutions specializing in the arrangement of financings. However, when counterparties are not readily available, certain of these arrangers take swaps into their own inventories, at least temporarily, by acting as principals rather than brokers.

Views on Use

Most participating companies, whether or not they currently employ swaps, are keenly interested in their emergence, viewing them as additional instruments in the hands of financial managers. Some see them as effective means of managing liabilities; others, as instruments for arbitraging markets and hedging assets; and, still others, as ways of overcoming constraints in entering international markets.

But participants also warn that swaps, though useful, are not without risk: namely, the possible failure of a counterparty to fulfill its side of the transaction. Fear of such an event has caused one participating company, an active user of international markets, to shun all swaps to date. It believes assuming an inferior credit risk would more than offset any rate or other advantage gained through swapping.

However, avoidance of unwanted exposures is only one of the reasons advanced for not engaging in swaps. Keeping away from the taxing requirement of engaging in a lengthy series of possibly market-disrupting swaps if the amounts involved are very large is also mentioned. So is the ability to gain access to fixed- and floating-rate markets competitively in a direct manner.

One participating utility company willingly enters currency swaps, but takes pains to avoid interest-rate swaps. By way of explanation, a spokesman notes that utilities are required to project interest-rate costs to secure rate increases from regulatory commissions. And commissions tend to come up with lower estimates of floating-rate debt costs than does the company. To avoid disputes in rate hearings, the utility opts for fixed-rate borrowings and steers clear of swaps to floating-rate debt, even though such swaps are potential expense reducers.

Here are some typical comments by respondents on the use of swaps:

> "We view the use of swaps as a good tool for asset and liability management. Since the swap market has become much more efficient, good arbitrage opportunities are no longer prevalent, but swaps do provide the ability to adjust duration and cut rate sensitivity on our portfolios."
>
> *Vice president and treasurer, a financial institution*
>
> * * * * *
>
> "We view the use of swaps as providing additional flexibility to obtain the lowest cost financing, rearrange maturities of existing borrowings, change the corporation's foreign currency exposures, and avoid the time-consuming and burdensome requirements of some foreign authorities."
>
> *Executive vice president, a manufacturing company*
>
> * * * * *
>
> "We view the use of swaps, both currency and interest rate, as providing important flexibility for our corporate financing activities—certainly allowing greater access to world capital markets than was previously possible."
>
> *Vice president and treasurer, a manufacturing company*
>
> * * * * *

Note Issuance Facilities

Also known as revolving underwriting facilities (RUF's), note issuance facilities (NIF's) are arrangements that give borrowers long-term access to short-term money. Organized in a variety of ways, the note-issuance facility has, since its recent introduction, won a growing number of adherents among governments, financial institutions and corporations.

Just what is a note-issuance facility and how does one work? The following concise description from a recently published study provides the answer:

"A note issuance facility is a generic term for a syndicated financing arrangement that guarantees an issuer access to a certain amount of funds for a prescribed length of time. At any time during the term of the facility, the borrower may request that a portion of the facility be drawn down, which results in an offering of short-term securities. These negotiable instruments are evidenced by promissory notes and are usually brought to the market for periods of one, three or six months. At the end of each interest period, notes may be repaid or offered in a new tranche. Notes are offered through a sole dealership or an auction mechanism to short-term investors. If an issuer's full request is not purchased by these investors, the notes are sold to a group of underwriting banks who commit, in advance, to purchase the notes at a predetermined spread, which is generally relative to LIBOR. Alternatively, these underwriting banks may provide funds through a separate lending arrangement. Underwriting commitments can run as long as 15 years, with the usual maturity in the five-to-seven-year maturity range."[1]

These facilities are often designed to meet the unique requirements of individual issuers and so differ from one another in certain respects. While many with NIF's or RUF's enjoy top credit ratings, some-lesser rated companies employ versions of them under which they issue grantor-underwritten notes.

Rationale for Establishing NIF's

These facilities, which often go undrawn, offer issuers several advantages. They sometimes serve as inexpensive backups for commercial paper. Note-issuance facilities also provide less expensive financing than other borrowings—floating-rate note issues, for example—because of inherent drawdown and timing rights. Notes under facilities can be issued at opportune times—perhaps at a point when rates have declined—whereas rates on floating-rate notes are usually set at predetermined intervals regardless of market conditions. And note-issuance facilities can be custom-made to meet the special demands of individual issuers.

[1]Gioia M. Parente, *Introduction to the Note Issuance Facility,"* Salomon Brothers Inc., March 1985, p. 1.

Several participating companies have near-term plans to launch NIF's or RUF's facilities. One, a retailer, recently did so because the revolving underwriting facility "complements and is consistent with the corporate strategy of diversifying capital procurement." Its chief financial officer sees the RUF providing the firm with several benefits: favorable positioning in the early stages of a new market, possible access to less than LIBOR rates on medium-term floating-rate borrowings, desirable exposure to new financing sources including international banks, and reductions in certain borrowing-related costs, especially those for rating and listing.

Roadblocks to International Financings

While some participating companies maintain that no serious obstacles stand in the way of using international markets, others disagree. Roadblocks, where perceived, relate more to foreign domestic capital markets than to the Euromarket. (See Table 6.)

Travel encumbrances, communication snags and procedural hitches that occasionally arise in connection with foreign financings annoy some respondents. For, the most part these are considered irritations, however, not dangerous obstructions barring access to international markets.

Foreign governments' rules and regulations, especially those controlling foreign exchange, are seen as impediments to foreign financings by some survey participants. Others view the incomplete development or insufficient depth in certain foreign markets in a similar vein, since these deficiencies sharply limit issue size. Still others consider the queuing systems imposed in some foreign countries as serious constraints that require issuers to await turns to offer securities packages.

While some respondents think the documentation of international financings is less complicated than that for domestic deals, not all share this persuasion. Dissenters believe paperwork problems associated with foreign borrowings cause delays and are expensive. Describing them as "maddening," an interviewed international financial executive claims documentation troubles often arise from legal hassles pitting opposing counsel in battles of words not easily resolved because prototype agreements are seldom available. Development of standard forms to document financial arrangements that involve different parties, currencies, lawyers and managements, would, in the view of some, go far toward resolving this difficulty.

Other, seldom-mentioned obstacles in the path of international financings include capacity limitations in certain currency-swap markets, and potential refunding problems for issuers because of the bearer nature of debt. The need to instruct top management on the merits of various international financing proposals is also cited. In the time required to convince decision makers to proceed, windows may close and opportunities evaporate.

Table 6: Obstacles to Use of International Markets

Obstacles	*Number of Mentions*
Minor nuisances (e.g., travel and communication difficulties)	14
Government restrictions	7
Capacity limitations	6
Queuing requirements	5
Documentation problems	4
Other (e.g.,)	4
Total	40

Some typical perspectives on hindrances to financing in international markets follow:

> "The quickened pace of worldwide financial deregulation has enabled the company to expand its presence and participation in foreign financial markets. The notable exception to this trend would be the company's consideration of a Euroyen or Samurai offering, both of which are currently prohibited by the Japanese Ministry of Finance."
>
> *Senior vice president, a financial institution*

* * * * *

> "The Euromarket continues to evolve and is competitive as a source of intermediate term funds. Foreign domestic capital markets vary considerably. In many countries where we have a need for funds, the capital markets are either nonexistent or not very well developed."
>
> *Corporate vice president and treasurer, a utility*

* * * * *

> "There are no serious obstacles in using the Euromarket; however, higher levels of documentation and queuing systems limit access to foreign domestic markets in Japan, Germany, Switzerland and France."
>
> *Senior vice president, a manufacturing company*

* * * * *

> "We see no obstacles that currently limit our use of the Euromarket. With regard to foreign domestic capital markets, obstacles include limited size of possible financings, limitations imposed by some national authorities on the use of proceeds, the queue system imposed by the national authorities of some countries, and burdensome documentary requirements in some markets compared with the relative simplicity of swap documentation."
>
> *Executive vice president, a manufacturing company*

* * * * *

Supplementary Readings

Much has been written about international financing in its various aspects in textbooks, special studies and the business press. A sampling, for readers wishing to obtain further background, follows:

Dileep Rao, *Handbook of Business Finance and Capital Sources*, Minneapolis, Minnesota: InterFinance Corporation, 1979, Chapter V, "Topics of Special Interest."

James C. Van Horne, *Fundamentals of Financial Management*, Englewood Cliffs, N.J.: Prentice-Hall, Inc., 4th Edition, 1980, Chapter 26, "International Financial Management."

Geoffrey Bell, *The Euro-dollar Market and the International Financial System*, New York—Toronto: John Wiley & Sons, 1973.

Roger M. Kubarych, *Foreign Exchange Markets in the United States*, New York: Federal Reserve Bank of New York, 1978.

Alan F. Snider and Michael J. Collins, *A Guide to Currency and Interest Rate Swaps*, Philadelphia: Robert Morris Associates, 1985.

Henry Kaufman and Jeffrey Hanna, *Prospects for Financial Markets in 1986*, New York: Salomon Brothers Inc., December 1985.

Ellen Pearlman, "A guide to the Japanese market," Institutional Investor, May 1983.

David Shirreff, "The Euronote Explosion," Euromoney, December 1984.

Randall W. Forsyth, "The $150 Billion Baby," Barrons, August 19, 1985.

Keith Wishon and Lorin S. Chevalier, "Interest Rate Swaps—Your Rate Or Mine, "Journal of Accountancy, September 1985.

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Research Bulletin

No. 199

The Conference Board

70th Anniversary

The 1986-87 Outlook: New Vigor for the U.S. Business Cycle

Summary of a meeting of
The Conference Board Economic Forum

Management Summary

- The Forum consensus adds up to a surprisingly favorable outlook, with economic activity expected to rise at a sturdy 3½ percent pace well into—perhaps through—1987.
- The energizing forces include lower energy costs, lower interest rates, and the "wealth effect" of higher equity prices. These favorable factors are operating in most of the industrial countries, so the good news is not just local but global.
- Not every sector of the U.S. economy is participating; notable exceptions are the oil patch, agriculture and capital spending.
- Although inflation and interest rates will firm noticeably, in the absence of any overheating both should stay within reasonable bounds.

Economic and Policy Analysis Program

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Tenacious Optimism—With Wild Cards

Edgar R. Fiedler

In contrast to many current stories about the economy, members of The Conference Board Economic Forum find themselves to be unusually optimistic and harmonious about the outlook for business into 1987. To be sure, the optimism is qualified in several respects: The rejuvenation of the cyclical expansion has not arrived yet. The capital goods, energy and agriculture sectors of the economy are not expected to join in the improvement. And there are several "wild cards" in the offing that must be surmounted.

Even with these qualifications, the Forum was tenaciously optimistic—and as confident as veteran practioners of the treacherous forecasting game are ever likely to be. The group looks for the business-cycle acceleration to show up in the summer months, and to continue into—perhaps through—1987. And we expect the reinvigoration to avoid anything more than mild inflation and interest-rate pressures. (See table of projections, top of page 4.)

Edgar R. Fiedler

Overall, a reassuring outlook.

This favorable prospect extends to most of the world. Lawrence Veit, our international specialist, labelled his outlook "Global Good News." He compared the present situation to a football team that is given five downs per series instead of the usual four—a change that would dramatically raise the team's chances of victory. One of the new factors is the drop in oil prices, which is redistributing an enormous amount of purchasing power from OPEC to most of the industrial world, and thus from savers to spenders. A second is the realignment of exchange rates, which are now far less disruptive to normal commercial transactions than a year or two ago. This change is, of course, especially beneficial to the competitive position of U.S. manufacturers and farmers.

The third favorable factor is the worldwide decline in interest rates with its stimulative impact on housing and other interest-sensitive sectors. The next is a group of disinflationary forces—in addition to the drop in oil prices and interest rates—including keen international competition, major corporate cost-cutting programs, and labor's willingness to cooperate in raising productivity and restraining wage demands. Finally, there is the presence now in many countries of pragmatic governments working toward smaller deficits, reduced government spending, deregulation and international cooperation.

To this impressive list, other Forum members added a variety of recent developments favorable to the U.S. economy. Albert Sommers mentioned generally comfortable consumer attitudes and the absence, except for automobiles, of an inventory overhang. He and several others noted the "wealth effect" of the stock market rise—the prospect that higher equity prices will increase consumer spending. Econometric studies tell us that this effect is not overwhelming, but with the real net worth of households up $600 billion over the past six months, it has to add up to a meaningful uplift for demand.

The Risks. In counterpoint to all these positive forces, a number of "wild cards" were mentioned—not wild cards in the sense of a junior-high-school poker game (all twos, fours and one-eyes wild) but in the sense of offsets to the optimistic factors and uncertainties that deepen the murkiness inherent in any assessment of the outlook. The most immediate uncertainty is why the prospective strengthening of the upswing is not yet at least partly visible in the current statistics. Looking ahead, no one sees the well-publicized troubles in the oil patch disappearing anytime soon. In agriculture, the declines in interest rates and the dollar have relieved some of the distress, but have not yet sparked a recovery. The lower dollar should boost foreign demand for grains and soybeans, but with so much new crop capacity in place around the world the improvement is likely to be very limited. The business cycle is in a mature phase, now half way through the fourth year of expansion, which attests to an absence of any unsatisfied pent-up demand for consumer durables and capital goods — demand of the kind that typically fuels vigorous growth in the early stages of cyclical recovery.

Indeed, the outlook for business investment spending has turned sour. This prospect reflects the substantial underutilization of productive capacity throughout manufacturing, the dramatic shakeout in oil, the overbuilding of office and commercial construction, and the first major cutback in demand for high-technology equipment. Direct investment by foreigners is expected to offset some of the shortfall, but only gradually. Thus, Stephen Roach anticipates a 3-percent drop in real capital outlays over the course of 1986.

Another signal of cyclical maturity is the elevation of the consumer-debt burden, which now appears to be a bit weighty. Several measures of credit delinquency have climbed to uneasy levels. Finally, although most of the group feels the U.S. international trade imbalance will soon start to recede, the change may come slowly. As in agriculture, the drop in the dollar has improved the U.S. position substantially, but Milton Hudson reported that many business executives feel exchange rates have not yet moved to anywhere near what is needed to make U.S. manufacturers competitively whole in world markets.

Other wild cards are to be found in the area of economic policy. The group is divided and unsure about the thrust of

THE FORUM CONSENSUS
Results of a Pre—Meeting Outlook Survey

	Latest Actual I85—I86	Projections 1986 IV85 — IV86 Avg	Range	1987 IV86 — IV87 Avg	Range
Economic Growth (Real GNP, percent change)	2.0	3.3	2.8-4.0	3.5	1.0-5.0
Inflation Rate (GNP Deflator, percent change)	3.0	2.7	2.0-3.2	4.0	3.0-5.0
	IV84-IV85				
Corporate Profits (After taxes, percent change)	4.3	7	0-15	5	– 3-15
	April	December		December	
Unemployment Rate (Percent)	7.1	6.8	6.6-7.4	6.7	6.4-7.5
	Current				
Commercial Bank Prime Rate (Percent)	8.5	8.75	7.25-10.5	9.25	7.75-12

Note: These forecasts were submitted by Forum participants in early May and are based on data available at the time.

Federal Reserve policy: Is it stimulative as suggested by the rapid growth of money (narrowly defined), by the drop in interest rates, and by the strength in housing? Or is it restrictive as suggested by the broader monetary aggregates and by the sluggishness in manufacturing? On the fiscal side, there are additional doubts, especially about the Gramm-Rudman-Hollings legislation and the efforts to revise the income-tax structure. First, if major tax reform is enacted, the pattern by which the changes are phased in will probably produce a half year of significant fiscal restraint. Second, despite the corporate rate cut, the prospective demise of the investment tax credit—a concrete, tangible, upfront subsidy to capital spending—is wreaking havoc with corporate rate-of-return calculations.

On the budget, most of us anticipate a reduction in the deficit from this fiscal year to next—in Lawrence Kudlow's calculations from $222 billion to $186 billion—but also find great obscurity about how much follow through is likely thereafter. Economic questions no longer dominate Washington politics as they once did. Issues such as terrorism, nuclear safety, runaway fathers, welfare and workfare now get more attention— but in a rapidly shifting and unpredictable pattern. As a result, both the public and the politicians are treading water, and the pressures exerted to curb the deficit have eased substantially. Until both the budget and tax issues get sorted out, the uncertainty is going to put a damper on business planning.

The Financial Environment. The discussion of inflation produced even less disagreement than the business cycle. Thanks to energy, the consumer price index will rise only about 2 percent this year. But the oil price drop is a nonrecurring event and, once the direct effects work their way through the system, the inflation rate seems almost sure to accelerate again. If the recent numbers for the consumer price index are recalculated after removing oil and food, the "core" rate of inflation is currently continuing at a 4-percent rate, which is the consensus projection of the Forum for 1987. Some analysts have suggested faster inflation ahead from price hikes on imported goods and on the domestically produced goods they compete with. According to Joel Popkin, however, the 1985-1986 dollar decline will not boost U.S. inflation as much as the earlier climb in the dollar curbed our inflation. The reason is the more-than-ample availability of both raw materials and manufacturing capacity worldwide, which will keep competition intense and prices in check everywhere. Unless the dollar declines a lot farther, therefore, inflation does not appear likely to accelerate to troublesome rates anytime soon.

In the credit markets, Kenneth Wright interprets the recent sharp drop in interest rates as more a consequence of changed market psychology than of Federal Reserve policy. Currently, the market is reevaluating its previously highly favorable assessment of Gramm-Rudman, inflation and Fed policy. Perhaps these sources of eased credit pressures are not as powerful and lasting as they initially appeared to be. By the final three or four months of this year, Wright feels, the strengthening of both economic activity and inflation will lead to a firming trend in market interest rates. Such a prospect seems consistent with Don Conlan's stock market outlook,

which calls for equity prices to be a bit spongy through 1987. Beyond that point, however, Conlan sees the equity markets as "very promising."

Summing Up. On balance, the economic positives clearly outweigh the negatives. Indeed, it is difficult to remember when so many significant expansionary forces were operating at the same time in so many countries. As a result, what earlier appeared to be a humdrum economic outlook has been transformed into a considerably brighter picture for some time ahead. The improvement has not arrived yet, but keep the faith, friends, it is on the way.

Some differences of opinion emerged among Forum members over the staying power of the U.S. expansion later in 1987, but these were differences not about direction but about the pace of growth: Would the expansion continue to be brisk or would cyclical fatigue slow it down? But overall, the outlook is reassuring. Unless Murphy's law takes over and the wild cards all prove especially damaging, 1986 and 1987 are likely to be years of simultaneous business-cycle expansion worldwide—not an explosive boom, but a solid steady advance. And without any overheating, inflation and interest rates should stay within reasonable bounds.

An Uncomfortable Bet on a Better Second Half

Albert T. Sommers

In the presence of a lot of confusion, reflecting frequent revisions and now a very improbable set of national-income accounts for the first quarter of 1986, optimism still prevails among forecasters for the second half of 1986 and for all of 1987. The optimism has strong and plausible roots in the economic policies that are being applied to the system, but most of these roots have been present for a considerable period of time, and the absence of a flowering into real growth is cautionary. The system gives the impression of being engaged in a tug of war, with extremely powerful pulls toward expansion on the one hand, and very heavy inertia on the other.

Albert T. Sommers

The optimism has strong and plausible roots.

Growth in the first quarter appears to have been significantly less than the 3.2 percent carried in the preliminary national accounts release, and no acceleration is visible thus far in the second quarter. Yet none of the typical signs of impending ordinary recession are present: Inventories have been conservatively managed; the national-accounts estimate of rapid growth of inventory in the first quarter look a little exaggerated, even granting that the price valuation of inventory would have been negative; outside of commercial construction and office equipment, capital goods demand has certainly not been excessive in relation to markets; no "fiscal drag" is yet visible in the federal budget; interest rates are not rising in response to a rising inflation rate; the positive attitudes of consumers and businessmen have recently been strengthening.

On the other hand, there is no real sense of cyclical growth; no reason to expect a burst of consumer spending, or of inventory demand. Capital goods orders have been moderate to weak; only the housing market appears to be in condition for a spurt of growth. The system gives the impression that the connecting pins that convey a cumulative business cycle from sector to sector have been pulled out; cumulation, either upward or downward, has not been visible in the system for two years.

This pattern of slow and tentative growth occurs in the presence of a degree of policy stimulus that would certainly have driven the system to full employment and on into inflation a decade ago. The budget deficit continues at a $200-billion rate; credit remains immensely available, at substantially lower rates than six months ago; the dollar has declined heavily against many relevant currencies, and most spectacularly against the yen — perhaps the most relevant currency of all. Securities markets delivered something like $100 billion a month in realized and unrealized capital gains in the six months from September to February. A borrowing frenzy has appeared in capital markets; in the fourth quarter, funds were taken down at an annual rate of $1.3 trillion. It is fair to ask why the response to all this has been so reluctant.

A first set of conditions — local, regional, but not necessarily temporary — would include the special recessionary conditions affecting parts of the system: agriculture, heavy industry engaged in the provision of basic capital stock, and, of course, the immense disruption of the petroleum industry. Private commercial construction (and, perhaps, up ahead public heavy construction as well) might be added to the list of sectoral casualties.

But other more fundamental considerations remain. The

two years of a quiescent growth rate have been years of disinflation, which affects incomes as well as prices. Growth in compensation has been slow; capital gains in the real world (that is, the nonfinancial world) have dwindled; personal interest incomes, which are equal to the entire payroll of manufacturing industries, have stopped rising. Because of these income effects, disinflation in the presence of high debt burdens is certainly, one would think, a constraint against rapid growth of demand. Aggregrate debt has continued to grow rapidly nevertheless, but without swelling real incomes and debt-carrying capacity.

And the U.S. trade position doubtless belongs on a list of longer-term restraints. The outside world is still supplying about 25 percent of all U.S. goods markets, despite a fourteen-month decline in the dollar. The trade position is still suffering from the lagged effects of a very high dollar in 1983 and 1984, which encouraged the establishment of sourcing arrangements abroad, and even of building capacity abroad to serve the domestic market. These may be temporary and reversible consequences,but the time required (and the level of the dollar required) to reverse them may still call for years of adjustment. The continuing high import propensity in the system tends to drain the stimulus originating in any part of it, and undoubtedly represents a major reason why such powerful policies have produced such modest results.

Despite the litany of problems, it would be surprising (and very unnerving) if the stimulus provided by present policies, and most particularly the decline thus far in interest rates, should not produce better economic performance in the last half of 1986, and this remains my own uncomfortable bet. But I do not think the moderate revival my model expects for the last half of 1986 should be carried through 1987. In that year, the United States will almost certainly confront the necessity of reducing the stimulative power of policy; the budget deficit should enter on a slow reduction, and the liberality of monetary policy will be constrained by a revival of price strength, attributable in part to the fallen value of the dollar. The U.S. consumption rate is too high for its present competitiveness in the world market, and its saving and investment rates are too low. Really vigorous economic performance will have to await a considerable and, in some degree, painful readjustment in these conditions.

Oil, Grambo and the Deficit

Lawrence A. Kudlow

The near-term negative impact on the 1986 Federal budget deficit is being forgotten in the euphoria over lower oil prices. The larger-than-expected Treasury refunding announcement supports the view that this year's deficit will reach $222 billion, $14 billion higher than the CBO estimate of $208, and $19 billion above the OMB projection of $203 billion.

In the short run, the 50 percent drop in oil prices is depressing both inflation and real GNP growth. This means that the level of nominal GNP in FY 1986 (October 1985 - September 1986) will come in below the government's budget assumption. And lower money GNP means reduced tax revenues and a larger deficit.

There is no question that the positive oil shock will, over time, stimulate economic growth, hold down inflation, and keep interest rates lower than would otherwise be the case. All this will reduce the budget gap in 1987 and beyond. However, the trick is getting from here to there.

Lawrence A. Kudlow

The 1987 deficit could fall to about $128 billion!

Economic Assumptions

In reports published last February, the CBO and Administration economic assumptions for 1986 (fourth quarter to fourth quarter) were quite similar: 4 percent real GNP; 3.5 percent CPI; 8 percent nominal GNP; 7 percent T-bill note; and, 9 percent Treasury bond rate. In recent quarters, both inflation and real output appear to be coming in lower than budgeted. Nominal GNP in FY 1986 is now projected to rise by 4.7 percent, not the 6.5 percent estimated by CBO. This leaves a shortfall of $56 billion in national income, roughly translating into a $16 billion loss in revenues.

Other factors will also significantly affect the 1986 deficit. Defense spending is running ahead of estimates made last February. Lower oil prices reduce revenues from the windfall profits tax and reduce leasing activity from the intercontinental shelf. Falling interest rates reduce net interest expense, though most of this positive deficit effect will not show until FY 1987. Finally, the delayed 1986 budget reconciliation (COBRA) low-

ers the deficit through a combination of spending and revenue measures.

Changes in CBO Baseline Projection for FY 1986 (in billion $)

February 1986 Baseline Deficit	−208
Revenues	− 16
Defense	− 5
Interest expense	+ 3
Oil prices	− 3
COBRA	+ 7
Net deficit change	− 14
Revised 1986 Baseline Deficit	−222

The lower level of FY 1986 GNP also affects the 1987 deficit. If nominal GNP rises next fiscal year by the budget's current 7 1/2 percent assumption, then revenues will fall short by about $16 billion. About $11 billion of this shortfall will be offset by lower interest rates, assuming market rates somewhere near present levels. This combination would raise the 1987 deficit estimate from $181 billion to $186 billion. Consequently, the "excess deficit" necessary to meet Gramm-Rudman-Hollings' (Grambo) target would be $42 billion, with a $32 billion excess above Grambo's $155-billion upper boundary.

Supreme Court and Sequesters

Enormous uncertainty surrounds the Supreme Court decision, although some Washington experts have little doubt that the Supreme Court will uphold the lower court's narrow decision that the role of the Comptroller General to implement automatic across-the-board spending cuts is unconstitutional.

In that event, Grambo moves to plan B and a joint report by the Directors of CBO and OMB would be transmitted to a joint committee of the Congress, made up of the entire membership of the House and Senate Budget Committees. This committee will report the contents of the CBO/OMB sequestration report in the form of a joint resolution to be passed by both Houses and approved by the President. If he signs, the sequestration would proceed.

Rather than another automatic trigger, Grambo B requires an up-or-down vote from the Congress. Of course, Congress could actually pass a budget resolution that meets next year's $144-billion deficit target. However, unless the tax and appropriations committees actually reconcile the spending and revenue measures contained in the resolution, the $144-billion deficit target will require a sequester. In recent years, budget resolutions have never been completely reconciled. The 1986 budget resolution of $55 billion in deficit-reduction measures was finally reconciled with only $7 billion in budget cuts and revenue increases.

Two other points are worth noting. First, it is possible that the Supreme Court will uphold Grambo. Some experts believe that the Comptroller General, with a 15-year term, is a creature of neither Congress nor the Executive Branch. Moreover, if the Court rules against Grambo, it might invite further lawsuits calling for the abrogation of other independent agencies, such as the Federal Reserve Board and the Securities and Exchange Commission. To avoid this, the Court might leave matters alone.

It is possible that the positive oil shock might sufficiently "energize" next year's economy to produce 5-6 percent real GNP growth, with only 3 percent inflation. This outcome would bring the level of FY 1987 nominal GNP back to the budget assumptions. So the $16-billion revenue loss would be made up, and the baseline deficit would come in around $170 billion, only $26 billion above Grambo's target. If Congress or the Supreme Court mandates a $42-billion sequester, and the oil factor works to increase growth and revenues, then the actual 1987 deficit could fall below Grambo's target to about $128 billion! This would lower federal borrowing and ease credit-market pressures in calendar 1987 and 1988, and would hold interest rates below where they might otherwise be.

In turn, economic growth (and particularly investment) would be stronger, thereby generating still more revenues and an even lower deficit outlook. This "virtuous circle" created by Grambo and cheap oil, could be an unexpectedly positive wild card in the overall economic and financial outlook.

The Challenge to Monetary Policy

James Tobin

James Tobin

The Fed must play its part.

The economic recovery in the United States has been stalled for nearly two years, during which time the unemployment rate has been 7 percent, plus or minus tenths, and capacity utilization has been around 80 percent. The coast is clear for the Federal Reserve to stimulate an expansion that would lower unemployment another point, reduce excess capacity to more normal prosperity rates, and raise the path of real GNP 2 1/2 or 3 percent. It would take two years of 4 to 4 1/2 percent real growth to complete the recovery in this way. No bottlenecks, shortages, scarcities or signs of inflationary pressure stand in the way. Should they appear en route, the Fed could slow the expansion.

The Fed's immediate challenge is the currently evident weakness of aggregate demand. To prevent a 1986 recession and to resume the long-stalled recovery probably will require further reductions in short-term interest rates. If these are coordinated with interest-rate declines in Europe and Japan, the world economy will benefit and the United States will gain from additional export demand. Fiscal support of domestic U.S. demand is already decreasing. The structural budget deficit is declining, and will fall even more sharply if Gramm-Rudman targets are met. We are well on the way to the correction of the monetary-fiscal mix that has long been needed, and the Fed must play its part in this correction.

There are, it is true, powerful positive demand forces in the offing. The depreciation of the dollar will improve net exports after the J-curve effects, from which we now suffer, are reversed. The spectacular decline in the long-short interest premium will gradually stimulate residential construction, and the decline in the cost of capital to business will help plant and equipment investment, which now appears to lag because of uncertainties about tax "reform" and because of excess capacity and the sluggishness of the economy. The decline in oil prices will stimulate consumption, eventually more than offsetting the negative effects on investment by the domestic oil industry. While these events might justify caution in monetary policy in 1987, or even late in 1986, they need not inhibit expansionary policy now.

Nor is there any reason for the Fed to "defend" the dollar from further decline by raising U.S. interest rates. Better, of course, to have foreign rates go down. But, in any case, it is likely that any further fall in the dollar would be arrested by expectations of its subsequent rise, without any rise in U.S. interest rates, which would be unjustified by domestic macroeconomic conditions.

Global Good News

Lawrence A. Veit

Lawrence A. Veit

The once-in-a-lifetime rally in stocks and bonds is no accident.

It is strange that so many observers now overlook the extraordinarily positive direction of world economic and financial developments. For most nations, real GNP is rising materially; disinflation is pervasive, proceeding in some countries to the point where consumer price indices are actually falling; and balance-of-payments disequilibrium appears to be declining in the course of 1986-1987. (See table.) To be sure, unemployment is still excessive; the indebtedness of selected nations, companies and individuals is too high relative to income levels; protectionism remains a serious threat; and markets are more volatile than is healthy for sound decision making. But these difficulties all seem to be easing with time. Moreover, domestic political environments are now more favorable to private enterprise than in many years — helping profits to grow — and international cooperation also seems to be seeing a new lease on life. In retrospect, the once-in-a-lifetime rally that has infected many countries' stock and bond markets is no accident. It may not be reversed soon.

Five related forces lie behind this admittedly optimistic conclusion.

(1) The price of oil has fallen, redistributing purchasing power to those who are likely to favor spending over saving. Some nations and some economic sectors will feel severe pain as a consequence of lower oil prices but, because the current period is in many ways the reverse of the arduous 1973-1983 years, the losses will be more than compensated for by gains elsewhere. Even assuming that the average cost of oil will rise to $18-$20 a barrel by the end of 1986, the GNP stimulus and the disinflationary impacts of oil will add up to a big plus for the world economy.

(2) Exchange-rate relationships today are far less disruptive to the progress of normal commercial transactions than in February, 1985, when the U.S. dollar was greatly overvalued. This means that U.S. manufacturers have had their competi-

World Economy: 1985-1987

	Real GNP (% Change)			*Consumer Prices (% Change)*			*Current Account Balance* ($ Billions)*		
	1985	*1986*	*1987*	*1985*	*1986*	*1987*	*1985*	*1986*	*1987*
OECD, total	2.8	3.3	3.7	4.8	3.5	4.3	–59.7	–14.0	–5.0
United States	2.2	2.7	3.8	3.6	2.5	4.4	–117.7	–104.0	–65.0
Other OECD	3.1	3.6	3.6	5.4	4.1	4.3	58.0	90.0	60.0
Japan	4.6	3.7	3.5	2.0	0.5	1.0	49.3	60.0	35.0
Canada	4.5	3.2	3.5	4.0	3.5	3.5	–1.9	–1.5	–1.0
Germany	2.4	3.8	3.5	2.2	0.0	1.0	13.1	19.0	12.0
France	1.3	2.6	3.0	5.8	3.5	3.5	0.3	2.0	1.0
United Kingdom	3.5	2.7	2.7	6.1	4.2	5.0	4.5	1.0	0.0
OPEC	2.5	2.5	4.0	9.5	8.0	8.0	–26.0	–30.0	–25.0
Non-OPEC LDCs	4.0	4.5	5.0	40.0	38.0	32.0	–25.0	–10.0	–15.0
Mexico	3.0	1.0	4.0	57.8	70.0	65.0	0.0	–2.5	–2.0
Brazil	8.0	6.5	6.0	274.2	145.0	50.0	0.0	0.5	–1.0
Other**	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	110.7	54.0	45.0

*Includes statistical discrepancy.
**Includes official transfers.
N.A. Not available.

tive positions restored to the point where they will now win larger shares of the U.S. and foreign markets — GNP will rise faster than domestic demand, and the merchandise-trade deficit will shrink. It also indicates that import prices abroad will be falling, increasing real purchasing power and thereby encouraging GNP growth to accelerate.

(3) Interest rates have declined sharply. In the first instance, this will encourage business investment and consumer spending, especially for durables. In addition, because interest is a major cost factor, lower rates may both spur profits and help curb price inflation. The indebted LDC's will also be major beneficiaries — in the case of Mexico and other oil exporters, lower rates will substantially mitigate the burden imposed by falling crude prices.

(4) All the above factors reinforce disinflationary tendencies. They are supported in this respect by (a) an increasingly keen international competition that features aggressive new exporters such as Korea, Brazil and India; (b) major corporate investment programs aimed at reducing costs; and (c) a new willingness of labor to compete by raising productivity and restraining wage demands. The progressive reduction in inflation rates due to these forces has given governments new opportunities to pursue expansionary policies without fear of reigniting double-digit inflation. Finally, if inflation is equated with uncertainty, the lower rates now prevailing are acting as a spur to investment and consumer spending.

(5) Pragmatic government policies in many countries now feature the reduction of budget deficits, lowering government spending as a share of GNP, privatization, deregulation, and international cooperation in such sensitive areas as interest-rate and foreign-exchange policy. Even though the results thus far leave much room for further progress, the change in direction — away from state intervention in the economy and an anti-entrepreneurial bias — is to be welcomed.

The foregoing analysis may appear euphoric against the background rhetoric of surrounding events such as the Tokyo meeting of Heads of State, congressional negotiations over budget reduction and tax reform, ongoing discussions with Mexico and other international debtors, differences between Europe and the United States regarding agriculture, and the OPEC meetings at which Saudi Arabia has confronted a number of its oil-producing allies with competition for shares of the world oil market. In fact, conflict is the essence of each of these negotiations and the ensuing friction may not be a serious threat to international prosperity. In recent years, particular instances of protectionist backsliding pale by comparison with the expansion of world trade. And, most important, the convergence of the major world economies and the new spirit of cooperation that emerged from the Group of Five meeting last September auger well for the world economy.

Prospects for further disinflation, real growth, and convergence appear even brighter in the wake of the recent Tokyo Summit. Dissatisfaction with anarchy in the foreign-exchange markets appears to have given way further to an official effort to prevent excessive volatility and aberrations in rates that distort commercial relationships. Consequently, exchange rates at the end of 1986 may be little changed from those now prevailing. It would be unrealistic to predict that the powerful stock and bond price surge of the past year will continue unabated. Nevertheless, it is now clearer than ever that the past rally has reflected improving economic fundamentals. It now remains to see whether the governments of leading countries can translate the lofty objectives of their leaders into the conditions for further economic prosperity.

Modestly Accelerating Inflation

Joel Popkin

Joel Popkin

Wage and price increases have slowed about as much as they are going to.

Because of the decline in oil prices, the consumer price index (CPI) will increase about 2 percent during 1986, its smallest increase for any year since 1965. Largely as a result, wages are likely to rise a bit less than their 4.1 percent increase of last year.

But wage and price increases have slowed abqut as much as they are going to and should accelerate during the rest of 1986 and 1987. There are two reasons to expect prices to accelerate. First, the end of the drop in gasoline and fuel-oil prices will remove a major drag on increases in the CPI. Second, depreciation of the dollar has already put upward pressure on prices, and that pressure will continue. Wages will pick up due to the acceleration in the CPI, but with a lag.

The likely uninterrupted growth of the economy this year and next should be an additional source of upward thrust to wages and prices. The only threat to continued growth is the unlikely prospect that the deficit will be cut to current Gramm-Rudman-Hollings targets and the Federal Reserve Board will not act in a timely way to offset the resulting contractionary impact. But the far greater likelihood is that the United States will contribute to and benefit from worldwide economic expansion, which could make the pace of expansion faster than currently anticipated.

In 1973, the world experienced strong economic growth, spurred by the simultaneous expansion of the economies of the major industrialized countries. That prospect is possible during 1986-1987. The climate for such a development arises primarily from recent monetary and/or fiscal policy developments in West Germany, Japan and the United States and the unleashing of substantial purchasing power among users of petroleum products. But one element of the 1973 experience will be absent — surging inflation. Worldwide excess supply of agricultural, energy and other industrial commodities and of manufacturing capacity should preclude any *sharp* acceleration of inflation, here or elsewhere, for several years.

The prospect of higher inflation in 1987, plus healthy economic growth, should stop the slide in long-term interest rates. They are likely to drift upward over the next six months.

A Brighter Outlook for Consumption and Housing

Milton W. Hudson

The sharp decline in oil prices has set in motion a train of events that has very favorable implications for both consumption and housing. Most importantly, consumers have had a windfall increase in real purchasing power; interest-rate levels have fallen significantly; and consumer wealth — reflecting sharply higher prices for stocks and bonds — has risen sharply. This improvement in fundamentals has transformed what had been a fair outlook for consumption and housing into something considerably brighter.

That is not to say that household spending is now likely to rise explosively. That might well be the prospect if the oil-price decline and the events that have attended it had occurred at an early phase of general business-cycle expansion. But we are not in the early phase of an expansion, and the best judgment is that the spending response to recent favorable developments — while significant — will be much more muted. We think that new staying power has been imparted to household spending at a time when it otherwise might reasonably have been expected to weaken.

We are, after all, in the fourth year of general cyclical expansion, without there being present anything like the kind of unsatisfied pent-up demand for consumer goods and housing that accumulates during recession. Instead, we have been through several years of quite vigorous household acquisition, characterized by spending increases that have outpaced income increases. This has resulted in a considerable buildup of household indebtedness and a notable slippage of the personal saving rate, which is now down to an anemic reading of about 4 percent. In historical perspective, indebtedness is now very high relative to income. And the frequency of credit problems has been growing sufficiently fast to generate quite a bit of worried commentary by creditors. This does not seem a particularly fertile environment for a surge in consumer spending. Certainly, the potential is much less than it would be if the personal saving rate were above 6 percent, as it was when the present cyclical expansion first got under way.

Milton W. Hudson

No ambiguity about the strength of housing.

Even so, on a fourth-quarter to fourth-quarter basis, our forecast is for real personal consumption spending to increase in 1986 by 3 1/2 percent. That would be moderately larger than 1985's rise in consumer spending, and it would represent very solid performance for the fourth year of cyclical expansion. (See accompanying table.) Given the seeming need for debt consolidation, we expect nondurable goods and services to benefit more from the recent improvement in fundamentals than big-ticket durables. Furniture and household appliances, to be sure, ought to register outsized sales increases this year

Consumer Sector

	Historical			*Projected*	
	1983	*1984*	*1985*	*1986*	*1987*
	(percent change, fourth quarter to fourth quarter)				
Real Consumption	5.3	3.4	3.0	3.5	2.1
Durables	14.5	9.2	5.8	4.0	1.3
Nondurables	4.3	2.0	2.7	3.5	1.6
Services	3.7	2.8	2.4	3.3	2.8
Real disposable income	5.1	3.9	1.3	3.2	2.0
Consumer price index	3.3	4.1	3.5	1.4	3.9
	(average rate, fourth quarter)				
Unemployment rate	8.5	7.2	7.0	6.9	6.8
	(millions of units)				
Housing starts	1.7	1.7	1.7	2.0	1.9
Auto sales	9.2	10.4	11.0	10.9	10.8
Truck sales	2.7	3.5	4.0	3.8	3.7

because of the strong advance now under way in housing. But, after several years of high-level auto and van sales, we are not projecting any further increase in vehicle deliveries this year. That view is reinforced by the lackluster showing of auto markets so far this year. On a fourth-quarter to fourth-quarter basis, we are projecting a slowing in 1987 in all categories of consumer spending, mainly because we believe that cyclical fatigue will develop as 1987 progresses. In assessing risks to our forecast, we do recognize that consumer-sentiment readings remain strong and that The Conference Board's buying plans index jumped very sharply in April—with gains broadly diffused among components of the index. For the moment, we are dismissing that April reading as a statistical aberration, since corroborative signs are not evident in the marketplace. But we are mindful that if our projections for consumer spending over the next several quarters are in error, they are more likely to prove too low than too high.

There is no ambiguity at the moment about the trend of housing activity. It is very strong, fueled by the sharp decline that has occurred in mortgage rates and the related rise in housing affordability. Despite oil-related difficulties in the South, we confidently expect a total of 2 million housing starts this year (which would be the highest total since 1978), and we are projecting almost the same number of starts in 1987. We are, of course, already at a 2-million rate for housing starts, and have been for several months. But that does not mean that the peak impact of housing on the general economy has already occurred. Completions follow starts by roughly half a year on average, which means that the direct bolstering effect of housing on GNP will continue for a considerable span ahead along with the indirect bolstering effects that arise from enlarged ordering and delivery of furniture, appliances and home furnishings.

Our anticipation that no significant backup will occur in interest rates generally and in mortgage rates, specifically, is critical to our favorable housing projections. From their cyclical peak of more than 14 1/2 percent in the Summer of 1984, interest rates on fixed-rate mortgages have fallen to the vicinity of 10 percent. We expect them to remain at that general level, thereby maintaining housing affordability for many buyers who had previously been effectively barred from the housing market.

A Very Weak Prognosis for Capital Spending

Stephen S. Roach

The capital spending outlook has taken a sudden turn for the worse. Business fixed investment (in real terms) declined at a 13 1/2 percent annual rate in the first quarter of this year — the sharpest drop in three years. Moreover, the near-term prognosis is grim. New orders for nondefense capital goods — an excellent barometer of pending deliveries of business equipment — fell at an 11.8 percent annual rate in the first quarter, after having been essentially unchanged in the final period of last year. Similarly, contracts for business plant construction — which provide a good forward look at business building activity — sagged appreciably in the first three months of this year. And, at the same time, the Federal Government's latest plant and equipment spending survey — conducted over the January to March interval — points to a 1 1/2 percent annualized drop in real spending over the second half of this year.

This abrupt weakening follows a capital spending rebound that was really quite extraordinary by past cyclical standards. Over the first two years of this expansion, real investment outlays cruised along at a 20 percent annualized clip — over twice the speed of the typical cyclical upturn. As the accompanying table illustrates, over that period investment gains were broadly based. Especially sharp increases were evident in purchases of motor vehicles and high-technology items. But capital spending growth then screeched to a standstill in 1985, and the bottom fell out in the first quarter of this year. What are the key factors behind this sudden turn of events?

Stephen S. Roach

A grim reminder of cyclical vulnerability.

Recent Investment Trends

	Average Annual Growth		
	1983-I to 1984-IV	*1984-IV to 1986-I*	*1985-IV to 1986-I*
Business Fixed Investment	20.4%	2.0%	– 13.6%
Basic Industrial	17.2	4.6	5.1
High Technology	29.6	– 3.5	– 35.6
Energy	13.0	– 2.3	– 23.1
Transportation	33.3	– 0.2	– 16.3
Other	15.0	8.9	5.2

A major consideration is that the existing stock of productive capital is being underutilized at present. By this stage in

a business cycle, capacity utilization in manufacturing has typically risen above 83 percent; by contrast, the factory-sector operating rate has been declining since mid 1984, and is now on the verge of moving below 79 percent. Whatever the cause — import penetration or a weakening of domestic demand — ample margins of slack capacity are a clear signal that corporate America does not need to bring more capital onstream to satisfy the needs of an economy still mired in a growth recession.

Another key consideration is corporate profits. Earnings in the capital-intensive manufacturing sector have been under steady pressure for over a year and a half. By the end of last year, factory-sector profits (including the inventory-valuation adjustment) still remained 20 percent below their mid-1984 peak. Protracted earnings pressure certainly brings into question issues pertaining to both the affordability and funding of business-spending programs. Aside from these general macroeconomic considerations, there are several relatively specific factors behind the deteriorating investment picture:

• First, the *oil industry* — which accounted for 8 1/4 percent of capital outlays in 1985 — is going through a dramatic shakeout. Following the sudden collapse in oil prices, major petroleum companies have slashed their 1986 capital spending budgets by around 30 percent. And since the latest plant and equipment survey points to "only" an 8 percent decline in petroleum industry spending and since this industry's investment share presently remains over one percentage point above its 15-year average, further energy-related adjustments underscore downside risks to the capital spending outlook.

• Second, *construction* overhangs have been apparent for some time in office and commerical building activity. Paradoxically, while nationwide vacancy rates for office buildings hit a record 16.5 percent in late 1985, office-building activity continued to ride the crest of an extraordinary cyclical upturn. Indeed, as of the first quarter of this year, such outlays remained at a level 48 percent above their mid-1983 low. Plain and simple: Unless there is a slowing of construction spending in this area soon, the stage could be set for a sharp and sudden collapse.

• Third, business demand for *high-technology products* remains depressed. IBM appears to have experienced its first major product cycle disappointment, and businesses in general are starting to raise some fundamental questions about programs that have led to the indiscriminate acquisition of the latest in trendy technology items. Such skepticism ultimately is healthy, however, and hardly seems surprising in light of our research, which points to what has thus far been a generally disappointing productivity payback of high-tech spending.

• A final negative for the capital spending climate is *tax reform*. For well over a year, Congress and the Administration have toyed with the notion that a comprehensive overhaul of this nation's tax system should include either eliminating or scaling back incentives such as the investment tax credit and depreciation writeoffs. Uncertainty as to the ultimate disposition of these tax-code provisions makes investment planning fraught with peril. Indeed, in this environment hurdle-rate calculations become problematic at best, and that potentially causes delays and outright cancellations of many capital spending projects.

All in all, there are dark clouds looming over the business capital spending outlook. Based largely on the factors enumerated above, we are looking for a decline of 3 percent in real business fixed investment from the fourth quarter of last year to year-end 1986, which translates into a 0.3 percent drop on a year-over-year basis. Such an anemic investment performance is virtually without precedent for an expansion year — the only exception occurring during the so-called "mini-recession" of the late 1960's. Thus, this gloomy investment outlook should also serve as a grim reminder of the cyclical vulnerabilities still faced by the economy at large over the near term.

Credit Markets in Transition

Kenneth M. Wright

Kenneth M. Wright

A firming trend in interest rates.

Conditions in the U.S. credit markets have undergone a remarkable change over the past six months, more dramatic in some respects than has been seen over a comparable period in recent memory. Long-term Treasury yields plunged more than three full percentage points, almost touching the 7-percent level, while Aa-rated utility yields declined more than 250 basis points to fall briefly below 9 percent in mid-April. Long-term tax exempts fared somewhat differently, moving lower in yield through early March until uncertainties over the effects of tax-reform legislation caused bond buyers to hold back. Since short-term rates fell by much less, only one percentage point or so, one result of the market realignment was a distinct flattening of the yield curve, reducing the spread between long- and short-term yields. By mid-April, market yields in many sectors of the credit market had fallen to levels not witnessed since late 1977 or 1978, when interest rates were rising rapidly — in contrast to their recent sharp retreat.

Causal factors behind the downward shift in market yields are not hard to identify. The Gramm-Rudman-Hollings legislation of last December brought a new optimism that sizable deficit reduction would actually occur, in contrast to the failed promises of earlier budget programs. Even with the constitutionality of the legislation in doubt, it was felt that Congress and the Administration had broken the long-standing impasse. Predictions of Federal Reserve easing became more frequent in November and December, and even though the markets had to wait until March for a half-point cut in the discount rate, trading psychology ran ahead of events and pushed down yields anyway. In early February, the larger-than-expected break in oil prices brought a fresh new outlook complete with forecasts of a close-to-zero inflation rate for the year, thereby justifying a further decline in nominal interest rates. Finally, foreign investors continued their active buying of U.S. Treasuries and corporates in spite of the decline in dollar exchange rates that had been fostered by the Group of Five agreement of late September.

Market response to this new atmosphere brought forth an upsurge in corporate bond issues, taking advantage of the lowest borrowing costs in many years. Gross new bond issues surged to a record $44 billion in the first quarter — equal to the full year total of 1983 — and in early May the calendar of forthcoming corporate issues was running over 50 percent ahead of a year earlier. Even more impressive, however, was the return to fixed-rate financing, which was used in 87 percent of first-quarter corporate issues, along with a greater share of maturities of 20 years and over. The transformation to long-term, fixed-rate borrowing at the most favorable yields in almost eight years suggested a return to the "good old days" before the inflation surge and the credit-market disruptions that followed the second oil shock of 1978.

Special conditions prevailed in the municipals market, however, in the period under review. State and local government issues hastened to utilize advance refunding opportunities in the closing months of 1985, before tax provisions changed the rules at year-end. The tax-exempt market was further clouded by the changing signals emerging from congressional proposals as to the taxability of certain types of issues, and new offerings sagged from their earlier highs. Tax-exempt yields moved lower for a time but then flattened and edged higher under a new threat from tax-reform proposals to subject municipal-bond income to federal taxes under a minimum-tax approach for high-bracket individuals. The volume of Treasury securities continued heavy, of course, with little abatement in the current federal deficit, but met with receptive markets in the face of domestic credit easing together with a substantial appetite from Japanese and European investors.

Credit markets presently are in the throes of a reevaluation of the fundamental assumptions on which the bond-market rally of recent months was based. Will the Gramm-Rudman-Hollings targets withstand the tests of constitutionality and the political pressures against both tax increases and spending cuts, or with elections coming up later this year, will we see only partial relief in fiscal 1987? Will the Federal Reserve pursue a path of further easing, perhaps with another cut in the discount rate, or will the monetary authorities feel that current rate levels and credit availability are sufficient to ensure a stronger pace of expansion for the balance of the year? Will the price of oil persist at recent lows or creep higher in coming weeks? And can we count on low inflation rates ahead, or will the lower dollar bring a new form of inflation as import prices begin to move up and push the indices higher? Finally, there have been signs that dollar securities have lost much of their appeal to foreign investors whose own currencies have risen against the dollar in recent months.

The new wave of doubts and uncertainties — some would say a return to sober reality — has already brought a halt to rising bond prices and an upward push in market yields. The potential for further downward moves in interest rates — based perhaps on weaker economic trends for the next few months — seems limited, in view of the substantial market adjustment that has already occurred. After all, the lower-dollar trend promises in due course to revive faltering export markets and to reduce import competition, with the latter factor bringing

along the unhappy corollary of more domestic inflation. And the lower level of interest rates should serve to sustain incentives to borrow and spend, not only for housing but also for business capital goods and consumer durables. The fundamentals are more firmly in place for a better pace of economic expansion in the latter half of 1986, continuing into next year, and it would be highly unusual in the annals of economic history if the expected acceleration in economic activity did not produce a firming trend in market interest rates during the latter months of 1986.

The Equity Markets: Past Is Prologue. Or Is It?

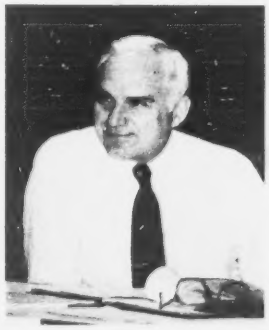
Don R. Conlan

There are many weird and wonderful ways of looking at the equities markets besides those fundamental but not terribly useful building blocks that we economists feel obliged to use. Indeed, I've poked around with this stuff for enough years to convince me that economists probably shouldn't even try. I believe the best stock market forecasters are pretty darn close to psychic in their sense of timing. Economists need too many facts. The good market forecasters go by the feel.

I could talk for the next half hour about the two key elements that drive stock prices: profits and interest rates. The former *pushes* up stock prices and the latter, translated into price/earnings (P/E) ratios, *pulls* them up. But can you think of two statistics that are more difficult to forecast, that have larger error potentials, or on which we do a worse forecasting job? And even if we got them right, we'd be frustrated by the variable leads and lags between these factors and stock price movements; as a result, we'd probably be bankrupt before we were proven right. Having said all that, I proceed.

I start with a very short view and follow that with a couple of progressively longer views. Let me offer the following maxim: In the very near term, there probably is no special upside limit to stock prices, nor any particular downside limit to long-term interest rates, unless and until a credible case can be made of oil prices having found a solid bottom:

- Sharply declining oil prices thoroughly drown any concerns people might have about inflation, almost regardless of what may be happening to prices elsewhere in the economy. With no certainty about oil prices, it's simply impossible for anyone to get very exercised about inflation and, even if they do, there's no reason for anyone else to pay much attention. You would expect declining inflationary expectations to come right straight out of long-term interest rates and they have. Since P/E ratios are the reciprocal of some discount rate applied to the flow of earnings, falling long-term rates generate rising P/E ratios. Rising P/E ratios pull up stock prices with or without underlying support from earnings.
- The initial effects of falling oil prices are negative in that they hit the energy-related sector of the economy immediately while benefiting the rest of the economy only with a lag.



Don R. Conlan

Earnings momentum definitely has slowed.

At the same time, they create a new batch of credit difficulties in the energy sector. Both these effects tend to induce the Federal Reserve to stick to an accommodative monetary policy. Tight money and rising interest rates are anathema to stock prices. Reasonable assurance of continued rapid money growth occurs usually only once in the business cycle, in the nascent stages of recovery. On those rare occasions when the market can detect such signals twice in the cycle, the results in the stock market can be quite heady, as we have seen. While the investor might be concerned about the long-run inflationary implications of protracted high money growth, he is not likely to worry about it much so long as oil prices keep falling.

That's the essence of the short-term view and, if close to the mark, helps to explain why stock and bond prices have risen far beyond expectations in the past six months even though earnings momentum has been disappointing. What can we say about oil prices? It seems to me that until the problem of oversupply of oil has been resolved—and that solution lies with Saudi-Arabia—the case for $10-15 per barrel as the bottom in oil prices is as yet unconvincing. Therefore, one cannot yet say that we have reached the limits of declining inflationary expectations nor that long-term interest rates have bottomed out. If not, then one cannot yet say that we have reached the limits on either stock or bond prices.

Now, let's take the intermediate view and look at the key

variables—profits and interest rates—and see where they might take the markets over the next 6 to 9 months. Earnings momentum definitely has slowed and I am having a terrible time getting a fix on the true path of profits this year. I started out last year with what was then a very conservative estimate for 1985 of $17.25 for the S&P 500 composite. By the time the year was finished and the effects of all the restructuring and associated writeoffs were taken into account (they say the writeoffs amounted to $1.30-1.80), actual earnings for that year slipped under $15.00. That's the worst mistake I've made in the several years since I began using a simple but useful little model based on changes in real GNP, the deflator and exchange rates. Earlier this year, I thought I had it all figured out and had allowed for the writeoffs but the first quarter has been disappointing as well. Oddly, as of now my estimate for *this* calendar year turns out to be the same $17.25. We'll see if it works any better this time.

Long-term Treasury bond rates are running about 7.50 percent but, as I implied in my short-run view, I don't think the decline in rates is over yet. The economy shows no evidence of breaking out of its 2 percent growth straitjacket; indeed, our analysts have been ragging me pretty hard lately about the validity of my projected second-half pickup. They aren't seeing it out in the field. Further, I see little opportunity for the Federal Reserve to tighten until the pickup happens and it is clear to all. While I don't expect long Treasuries to go below 7 percent, I do think they will go back to near that level again in the next few months. After that, assuming that money has not lost its powers of economic stimulation and assuming that oil prices do find a bottom in the next few months, I think it's reasonable to expect some rise in rates as we approach year-end.

Using $17.25 for the S&P and the reciprocal of my expected low of say, 7.25 percent on the long Treasury as a proxy for the "appropriate" P/E ratio, (13.8X), the S&P is correctly priced at its present level of 235-240 but it's no bargain. It's no bargain because if I'm wrong on profits I probably have them too high and I can't expect another big drop in interest rates to bail me out. The market over the past 9 months has been pulled up by declining interest rates (and, consequently, rising P/E ratios). It certainly has not been pushed up by earnings growth! Thus, as soon as it becomes clear that interest rates have bottomed out, we will see a lot of attention paid to earnings potential. If the long-awaited second-half economic pickup doesn't materialize, the earnings potential won't be there.

The second half pickup, if it comes along as I expect it to, may also mark the end of the decline in long-term interest rates. Taking 8.50 percent as a possible bond rate in early 1987, and S&P earnings estimates of $17.25 this year and about $19 for 1987 (up 10 percent in a strong-growth environment), equity prices on this basis appear to be a bit full despite strong profits growth. That's the intermediate term view of the market.

Now, there's another approach to the markets that may appear to border on the technical but, in fact, does have its foundations in economic logic. I refer here to the Presidential economic cycle. Presidents, particularly Republican Presidents, tend to do different things at different stages of their terms, with pronounced results for the stock market.

A look at the postwar record for Presidential terms shows that we always have a recession in the first half of a Republican's term and it has been that way with all Republicans back to and including Herbert Hoover. Under Democrats, you never get a recession in the first half of the term. Now, there are several ways to interpret this but, at least from a Republican standpoint, one interpretation might be that the Democrats get to throw all the parties and the Republicans have to clean the house and do the dishes afterwards.

Curiously enough, however, under either Republicans or Democrats, the stock market tends to do virtually nothing in the first half of a President's term. Of course, within that two-year period there can be tremendous volatility so that, if your're in the market, you would hardly characterize the market as "doing nothing." But that's the way it works out over the full two-year period. Now, if past is prologue, what does that mean for the near-term market outlook? Well, the S&P 500 index is now 235-240. In order for it to be where it's supposed to be by the fourth quarter of this year—that is, in order to make it virtually flat versus two years ago (1984 fourth quarter = 165), the market will have to fall quite a lot between now and then. Wow! Let's hope that, in this case, past is not prologue. Is it?

President Reagan appears likely to break the pattern of recessions in the first half of all Republican Administrations. Interesting! Do you suppose it's because his policy actions, particularly the huge budget deficits, are more like those of a Democrat, or what? So much for the first half of a President's term. What about the second half? Curiously, from the midpoint on, it hasn't seemed to make much difference which party was in the White House. We tend to get some solid gains in the economy from either party *and* we never have recessions—well, almost never.

Regardless of party, the market tends to go up 32 percent in the second half. To show how representative that number is, six out of eight times in post-World War II history, the gain was in the range of 30 to 48 percent. In 1960—when the Republicans made the fatal mistake of having a recession in the second half of the term—the market did not produce the requisite result. (It was up only 6 percent.) Again, in the second half of Reagan's first term, the market rose only about 20 percent but two months later, in February, 1985, it was up exactly 32 percent from the fourth quarter of 1982.

So, from this point of view as well, the market appears a bit overblown relative to past history. But that's because we've always had a recession right about now in a Republican administration. I don't think we're headed for a recession any time soon. If not, then we will have made it through the toughest period for the equity markets relative to the Presidential economic cycle. After the end of this year, as policy begins to focus intensively on the 1988 elections, the risks for the market will be markedly lower. One might almost say it's now or never for market weakness; that is, if we don't get a market

correction in the next 6-9 months, chances are we won't have one through 1988.

Stringing these three views together, I'd say there's a little upside left while oil prices continue to plumb for a bottom but, thereafter, economic fundamentals suggest that equity prices may be a bit spongy through early 1987. Beyond that, things look very promising for the equity markets—if past is prologue. Ah, there's the rub.

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